2010

Insurance industry developments - 2010/11; Audit risk alerts

American Institute of Certified Public Accountants (AICPA)

ISBN 978-1-93735-007-9

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2011/12

Insurance Industry Developments

AUDIT RISK ALERT

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

AICPA®

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ISBN 978-1-93735-007-9

Notice to Readers

This Audit Risk Alert replaces *Insurance Industry Developments—2010/2011*.

This Audit Risk Alert is intended to provide auditors of financial statements of insurance entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance Kim Kushmerick provided in creating this publication.

The AICPA gratefully acknowledges the following individuals for their essential contributions in creating this publication:

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Feedback

The Audit Risk Alert *Insurance Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your insurance audits and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. This alert is intended to be used in conjunction with the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223312), which explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

Property and Liability Insurance Industry

.03 The top trends for the property and casualty industry through the first half of 2011 were the large impact of catastrophes on the insurers' profits, cautious optimism on moderating pricing conditions in the commercial lines market, and the potential impacts of the uncertain economy on exposure growth and investment returns.

Catastrophes

.04 The property and liability insurance industry experienced unprecedented weather-related losses in the first half of 2011. According to a Swiss Re[1] report dated September 9, 2011, the total first half of 2011 insured catastrophe losses were $70 billion compared with $29 billion in the first half of 2010 and $45 billion for the total fiscal year of 2010.

.05 The most costly events in the first half of 2011 were the earthquakes in Fukishima, Japan ($30 billion), and Christchurch, New Zealand ($10 billion),

[1] See www.swissre.com/media/news_releases/nr_20110909_sigma_factsheet.html.

as well as multiple tornados in the Southern United States ($12.5 billion) during the spring. In addition to the events of the first half of the year, the National Oceanic and Atmospheric Administration (NOAA) has projected an above-average hurricane season, with 12–18 named storms and 3–6 major hurricanes expected during the period from June 1 to November 30, 2011. Through August, there have already been 12 named storms and 2 major (category 3+) hurricanes. Regarding the most recent disaster and as discussed in "U.S. P/C Industry to Absorb Losses from Hurricane Irene" in the August 30, 2011, *Best's Briefing*, AIR Worldwide has estimated that insured losses from Hurricane Irene are expected to be between $3 billion and $6 billion in the United States. Competitor EQECAT, Inc., has a narrower range for insured losses: from $1.8 billion to $3.4 billion in the United States and the Caribbean. The ultimate losses related to Hurricane Irene are also dependent on the determination of the cause of the loss: whether by wind or flood and whether the storm was a hurricane or tropical storm in each location. Once this information is determined, the applicable policy provision and deductible information, as well as reinsurance coverage, can be quantified, and a narrower loss estimate should be available.

.06 Further, the series of tornadoes and hailstorms that hit the Midwest and Southeast United States in April and May, including those causing heavy damage in Tuscaloosa, AL, and Joplin, MO, along with flooding, drought, and wildfires, adversely affected the U.S. property and liability insurance industry. According to NOAA, a preliminary count of 1,549 tornadoes has been reported as of June 21, 2011. The actual tornado count was 1,282 in 2010, and the 3-year average is 1,376. The Joplin tornado, which the National Weather Service rated an EF-5 (the highest power and intensity rating) on the Enhanced Fujita Scale, is the deadliest single tornado since modern recordkeeping began in 1950, according to NOAA.

.07 The U.S. reinsurance segment recorded an underwriting loss in the first quarter of 2011, driven by global catastrophe events, including the earthquake in New Zealand and the major earthquake and related tsunami in Japan.

Pricing

.08 Many surveys have indicated that commercial lines pricing may be stabilizing, but industry commentators remain cautious. The Risk and Insurance Management Society, Inc., pricing survey suggests that the soft market may be bottoming out. The survey indicates significant tightening in the price declines that have defined the soft market. "Pricing has been fairly stable in three of the last four quarters, but it is too early to declare the soft market over," says Dave Bradford, Advisen executive vice president and editor-in-chief of the survey. "Rates may have stabilized for now, but barring major catastrophe losses, there are few signs of materially higher premiums on the horizon." Such sentiment was confirmed by the Council of Insurance Agents & Brokers pricing survey. Commercial property and workers' compensation were the only two lines showing average increases.

Investment Trends

.09 Property and liability insurers continue to feel the effects of concerns in their investment portfolios that the global economy is heading toward a "double-dip" recession. Through August 2011, the S&P 500 is down 5.1 percent.

Overall, the economy has slowed on fears of potential European sovereign debt defaults. The global recession and general market sentiment has led several analysts to believe that equity markets may drop further by year-end.[2]

.10 Meanwhile, insurers have not seen the long-expected increase in interest rates on their fixed income portfolios. In its most recent press release, the Federal Open Market Committee[3] kept the targeted federal funds rate range at 0 percent to 0.25 percent and expects to maintain exceptionally low rates through mid-2013. As a result, reinvestment opportunities on the fixed income market are bleak. Investment results will continue to see a downward trend while portfolios mature. Companies are investing more in short-term investments because longer-maturity securities are not offering the rates to allow insurers to meet their return on equity targets. This has led to U.S. Treasury bonds seeing an increase in demand, further lowering their rates, even though the U.S. government lost its AAA rating from Standard & Poor's (S&P) in August 2011.

.11 Although the impact is not as great as it is to its life insurance counterparts, property and liability insurers are monitoring the commercial mortgage-backed securities (CMBS) market because the valuations of those investments were thrown into question upon S&P's announcement that there were inconsistencies in their models. S&P has halted rating new CMBS structures and is evaluating the impacts on previously structured deals.

Life and Health Insurance Industry

Impact of U.S. Economic Conditions on Life Insurers

.12 A.M. Best modified its rating outlook from negative to stable for the life and annuity segment in July 2010 (reaffirmed in January 2011), due to the improvement in U.S. economic conditions and the financial condition of the industry.[4] However, on July 19, 2011, A.M. Best indicated that it was considering revising its rating outlook for the U.S. life and annuity segment from stable to negative based upon continuing economic weakness.[5] The financial results of the life and annuity industry have continued to be highly correlated with the direction of interest rates and equity market performance. In a November 2010 Towers Watson survey, it was reported that life insurance industry CFOs believed that the economic environment was the key challenge for 2011 in terms of achieving growth, profit, and risk targets.[6]

.13 According to A.M. Best, the industry's capitalization at current rating levels was adequate and could withstand the impact of additional stress scenarios incorporating moderate impairments and measured economic growth.[7] The significant influence of economic conditions on life and annuity companies

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[2] See www.bloomberg.com/news/2011-09-12/s-p-500-may-plunge-21-bank-of-america-says-technical-analysis.html.

[3] See www.federalreserve.gov/newsevents/press/monetary/20110809a.htm.

[4] "Life/Annuity Insurers Regain Ground as Economy Strengthens" in the February 21, 2011, *Best Special Report*.

[5] "U.S. Economy: P/C Sector Steady, Life Industry More Vulnerable" in the August 9, 2011, *Best's Briefing*.

[6] See footnote 4.

[7] "A.M. Best Maintains Stable Rating Outlook On U.S. Life/Annuity Sector" in the January 10, 2011, *Best's Briefing*.

had initially resulted in improvements in reported results in late 2010 and early 2011 due to the following:

- Trends pertaining to credit spreads
- The performance of equity markets
- Consumer confidence
- Levels of disposable income[8]

.14 However, it has been predicted that the interest rate environment will remain low for the foreseeable future, which presents a problematic scenario for the life insurance industry. Low investment yields will likely affect the profitability of life insurers because they rely on the spread between investment income and investments credited to policyholders. A.M. Best expects life insurers to utilize highly developed risk management capabilities to manage their interest rate risk, which is significant given their high proportion of fixed income investments and substantial exposure to interest-sensitive products.[9]

.15 As a result of the financial crisis, life and annuity companies have taken greater focus on liquidity levels at the operating and holding company levels and overall balance sheet strengthening. Life and annuity companies are also aiming for more robust capital positions, reductions in investment losses, and improvements in risk management in order to position themselves for future growth and improved earnings. A.M. Best reported that life insurers believe that they are adequately prepared for stress scenarios, including the scenario supported by recent data expecting further economic downturn, volatile equity markets, and the increased possibility of a "double-dip" recession.[10]

Health Care Reform and Industry Outlook

.16 The Patient Protection and Affordable Care Act (PPACA) was signed into law in March 2010. The requirements from this law will become effective for health insurers in phases between 2010 and 2014. The 2010 requirements included dependent coverage up to age 26, no lifetime maximums on dollar value of coverage, no rescissions, and preventive care with no cost sharing. In order to comply with these requirements, health insurers adjusted pricing to offset the additional costs.

.17 At year-end 2010, A.M. Best reported that of the rated population of health insurers, 76 percent had a stable rating outlook, 21 percent had a negative rating outlook, and only 3 percent had a positive outlook. However, the percentage of companies with a negative rating outlook had decreased by 6 percent, from 27 percent at year-end 2009.[11]

.18 A.M. Best expects that health insurers will report declines in underwriting income and margins during 2011 despite experiencing an improvement in financial stability during 2010. Concerns regarding the implementation of health care reform items that will be phased in during 2011 and the expectation that commercial enrollment will remain flat or experience nominal growth

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[8] See footnote 4.

[9] See footnote 4.

[10] See footnote 5.

[11] "Gradual Improvements Have Rating Trends Leaning Toward Equilibrium" in the March 7, 2011, *A.M. Best Special Report*.

have led to such expectations and a continued negative outlook for the industry by A.M. Best.[12]

.19 The PPACA requirement for a minimum medical loss ratio requirement will become effective during 2011. This will require health insurers to pay rebates to policyholders in 2012 if their aggregated state loss ratios fall below a specified minimum. Individual and small group blocks and the large group segment will be required to maintain minimum loss ratios of 80 percent and 85 percent, respectively. In order to comply with this requirement, health insurers have reportedly adjusted benefits and pricing; however, A.M. Best expects that this requirement will result in lower margins. The PPACA requirement for rate reasonableness will also become effective for rate filings on or after July 1, 2011. This will require health insurers to justify rate increases in excess of 10 percent. Regulators will then have the ability to modify the amount of requested increases. As a result of this requirement, the expectation is that the review process may take longer, and the implementation of rate increases may be delayed. In addition to the impact of specific PPACA requirements on the financial position of health insurers, the implementation of system and procedure changes associated with these requirements is also expected to be costly, and compliance with such requirements may require major information systems programming.

.20 Moreover, A.M. Best reported that health insurers believe that they are adequately prepared for stress scenarios; however, the industry will continue to face challenges of growing during a sluggish economic recovery while operating under additional regulatory controls.[13]

Legislative and Regulatory Developments

Recent Statutory Accounting Principles

.21 The National Association of Insurance Commissioners (NAIC) continues to develop and clarify statutory accounting guidance for insurance enterprises through its ongoing maintenance process. The most recent *Accounting Practices and Procedures Manual* was published by the NAIC as of March 2011, and online updates contain accounting practices and procedures adopted by the NAIC through August 2011. Updates to the manual can be found under the Statutory Accounting Principles Working Group section of the NAIC website. Insurance laws and regulations of the state insurance departments require insurance entities domiciled in those states to comply with the guidance provided in the manual, except as otherwise prescribed or permitted by state law or regulation.

.22 The 2011 manual contains the following three new or revised Statements of Statutory Accounting Principles (SSAPs) that were adopted through December 2010:

- SSAP No. 5R, *Liabilities, Contingencies and Impairments of Assets*, was revised to adopt Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 460, *Guarantees*, with modification. The revisions require entities to recognize,

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[12] "Reform Requirements Likely To Impact Insurers' Margins" in the February 14, 2011, *A.M. Best Special Report*.

[13] See footnote 5.

at the inception of a guarantee, a liability for the obligations that it has undertaken in issuing the guarantee, even if the likelihood of having to make payments under the guarantee is remote. Statutory modifications to FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*, include initial liability recognition for guarantees issued as part of intercompany or related-party transactions, assessment and recognition of noncontingent guarantee obligations after recognition and settlement of a contingent obligation, and a revision of generally accepted accounting principles (GAAP) guidance to reflect statutory accounting terms and restrictions. The newly adopted guidance is effective December 31, 2011.

- SSAP 35R, *Guaranty Fund and Other Assessments*, was revised to adopt, with modification, FASB ASC 405-30. The revised SSAP modifies the conditions required before recognizing liabilities for insurance-related assessments. Under the new guidance, the liability is not recognized until the event obligating an entity to pay an imposed or a probable assessment has occurred. This affects prospective premium-based guaranty fund assessments because the event that obligates the entity is the writing of, or becoming obligated to write or renew, the premiums on which future assessments are to be based. The newly adopted guidance was effective January 1, 2011.
- SSAP No. 91R, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, reflects updated guidance for securities lending activities and was effective December 31, 2010.

.23 Several nonsubstantive revisions to various SSAPs and manual appendixes were made during 2010 by the NAIC. Interpretations are immediately effective upon adoption by the NAIC, and new SSAPs occasionally are effective for the calendar year in which they are adopted. Several of the nonsubstantive revisions to be aware of include the following:

- SSAP No. 10R, *Income Taxes—A Temporary Replacement of SSAP No. 10*. Extended the sunset provision through 2011 and incorporated additional disclosures for tax-planning strategies.
- SSAP Nos. 51, *Life Contracts*; 52, *Deposit-Type Contracts*; and 61, *Life, Deposit-Type and Accident and Health Reinsurance*. Revisions expand the disclosure requirements for annuity actuarial reserves and deposit liabilities by withdrawal characteristics.
- SSAP No. 52. Revisions incorporate an annual statement disclosure on retained assets.

.24 On August 31, 2011, the Statutory Accounting Principles Working Group adopted SSAP No. 101, *Income Taxes—A Replacement of SSAP No. 10R and SSAP No. 10*, which is effective for annual periods beginning January 1, 2012. The method of determining deferred tax asset (DTA) admissibility has the same basic steps as in SSAP Nos. 10, *Income Taxes*, and 10R, using three components to calculate the admitted portions of DTAs.

.25 The first component of the DTA calculation admits the same IRS carryback provisions included in SSAP No. 10R not to exceed three years, but unlike SSAP No. 10R, there are no risk-based capital (RBC) restrictions. The second component of the DTA admissibility calculation limits admitted DTAs to the amount years (X) during which the DTAs are expected to be realized and a percentage of adjusted capital and surplus (Y). X and Y are determined using separate tables for RBC, non-RBC, and mortgage and financial guaranty insurance entities. The following table for RBC reporting entities determines X and Y based on the percentage of adjusted capital and surplus compared with the RBC authorized control level.

Ex-DTA Capital and Surplus and Authorized Control Level RBC (%)	***Paragraphs 11(a) and 11(b)(i) of SSAP No. 101 (X)***	***Paragraph 11(b)(ii) of SSAP No. 101 (Y)***
Greater than 300%	3 years	15%
200%–300%	1 year	10%
Less than 200%	0 years	0%

.26 The capital and surplus used in the preceding table excludes the impact of any net DTAs, electronic data processing equipment and operating system software, and net positive goodwill as of the current reporting date. This is a change from SSAP Nos. 10 and 10R in which the capital and surplus used to determined DTA admissibility was from the most recently filed quarterly statement.

.27 The third component of the DTA admissibility test allows for DTAs not meeting any other admissibility requirements to be admitted to the extent that they offset existing deferred tax liabilities. Offset must be permitted under existing laws while considering the tax character and reversal pattern.

.28 In addition to the mechanics of the calculation of DTAs, SSAP No. 101 rejects FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, which is now part of FASB ASC 740, *Income Taxes*, although the realization criteria of more likely than not (a likelihood of more than 50 percent) has been added instead of probable, as currently used in SSAP No. 5R. Readers should note that changes have been proposed to SSAP No. 5R to align the guidance for tax contingencies with the more likely than not thresholds adopted in SSAP No. 101. SSAP No. 101 also more thoroughly addresses the subject of realization of tax benefits and tax planning than previous guidance. Auditors should monitor NAIC releases for SSAP No. 101 implementation guidance, which is expected to be released in the first quarter of 2012.

.29 At the NAIC Spring 2011 National Meeting, regulators noted that there were differing views on the application of Actuarial Guideline (AG) 38 for certain no-lapse guarantee universal life insurance products. In September, the NAIC Life Actuarial Task Force (LATF) exposed for comment a draft communication expressing the LATF's interpretation of the appropriate application of AG 38 to these products. At this point, there is no indication of if or when any final interpretation of the guidance will be issued. Auditors should closely monitor the status of the proposed interpretation. In the absence of a finalized interpretation, auditors are reminded that they have to obtain sufficient evidence (which may be communication with the insurer's regulator) of the insurers' assertions that their domiciliary regulators concur with the insurers' interpretation of the appropriate application of AG 38.

Audit and Accounting Developments

Audit Considerations

.30 The recent economic conditions and weather-related losses may cause additional risk factors for insurance entities. Some risks that may affect an insurance entity are the following:

- Complex estimates and significant measurement uncertainty related to property and liability claims and claims expense
- Obtaining a complete understanding of reinsurance agreements and any side agreements
- Extended low interest rate environment
- Complex determination of the health care reform medical loss ratio and related rebates
- Litigation related to the applicability of insurance contracts to catastrophes
- Constraints on the availability of credit and capital
- Potentially erroneous or fraudulent activity due to decreased staffing and the resurgence of business activity
- The continuing evolution of the postrecessionary marketplace

Claims Expense and Loss Reserves

.31 Property liability claims and claims expense, including losses from hurricanes and other types of catastrophes, are complex estimates. Due to the increased number and complexity of transactions surrounding claims and claim expenses, inherent risk surrounding the recording and determination of the payout of claims can increase. Auditors should evaluate their client's response and adherence to criteria and related controls surrounding expenses.

.32 The identification of changes surrounding valuation variables and consideration of their effect on losses are critical audit steps. The evaluation of these factors includes the involvement of specialists and input from various operating departments within the entity, such as marketing, underwriting, actuarial, reinsurance, and legal. Readers should remember that losses are only accrued for events that have occurred; catastrophe reserves are not allowed in anticipation of events. Consideration should also be given to the guidance in FASB ASC 450, *Contingencies*.

.33 AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. Claims expense and loss reserve estimates are significant variables on an insurance entity's financial statements. Accordingly, regardless of the approach used to audit claims expense and loss reserve estimates, the auditor should gain an understanding of how management develops estimates. Additionally, chapter 4, "The Loss Reserving and Claims Cycle," and appendix A, "Additional Audit Considerations for Loss Reserves, Premiums, Claims, and

Investments," of the Audit and Accounting Guide *Property and Liability Insurance Entities* is an additional source of guidance.

.34 Auditors also can refer to AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), as well as noting current practitioner prohibitions and restrictions that exist related to the performance of nonaudit services for audit clients, including certain actuarial services. Practitioners should be aware of, and comply with, these prohibitions and restrictions, including the AICPA, the Securities and Exchange Commission, the Public Company Accounting Oversight Board, and the NAIC independence rules, and rules passed by the U.S. Government Accountability Office, state licensing boards, and others.

Reinsurance Contracts

.35 Auditors of entities that have significant reinsurance activities should gather sufficient information to understand the economic substance of the individual reinsurance contracts and to conclude that both significant insurance risk and a reasonable possibility of the reinsurer incurring a significant loss (risk transfer) exist. In order for the reinsurer to assume significant insurance risk under the reinsured portions of the contract, the amount and timing of the reinsurer's payments are required to depend on, and vary directly with, the amount and timing of claims settled under the contract. Many factors influence the risk transfer analysis, including the determination of reasonably possible loss scenarios and the related effect of specific contractual features that may have loss-limiting characteristics, such as loss caps, loss corridors, profit commission, ceding commission, or experience rate adjustments. The existence of loss-limiting features in the contract increases the complexities and judgments necessary for the risk transfer analysis.

.36 If the insurer is a regulated insurance company, the auditor should obtain a copy of the reinsurance attestation signed by the CEO and CFO that is filed with the insurer's NAIC annual statement. This reinsurance attestation positively asserts that the reinsurance contracts have been accounted for properly, in accordance with statutory accounting principles, and that for every contract in which risk transfer is not reasonably self-evident, then documentation will be maintained supporting the existence of risk transfer. The risk transfer requirement applies to accounting for reinsurance contracts for both statutory basis accounting and GAAP. The auditor should obtain the client's risk transfer documentation and evaluate the quality and completeness of this information.

.37 Auditors of entities with significant reinsurance contracts may also want to request that management state in its representation letter that the auditor has been informed of any side agreements that are part of reinsurance contracts for the purpose of determining whether the entity has considered properly these agreements in the accounting analysis for the contract. Auditors also may consider the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), when evaluating these arrangements to identify the following:

- Contracts backdated to avoid retroactive reinsurance accounting on coverage of losses that had already been incurred
- Side agreements to reimburse the reinsurer for covered losses or return profits under a contract in a different accounting period, which may compel accounting accruals

- Linked contracts through which losses experienced under one will be reimbursed under another in the future and that should be considered together in the risk transfer analysis
- Contracts whose terms do not make economic sense and indicate a side agreement or linkage with another contract that should be considered in the accounting evaluation
- Exclusive reinsurance arrangements with offshore assuming companies that raise consolidation questions
- Commutations in which the settlements are not in accordance with contract terms and suggest a noncontractual agreement on the allocation of profits and losses
- Contracts under which the risk transfer analysis supporting the accounting evaluation differs materially from, and cannot be reconciled to, cash flow analyses included in the underwriting file

Reinsurance Recoverables

.38 FASB ASC 944, *Financial Services—Insurance*, provides guidance on the recording and reporting of recoveries of losses that are reinsured. Consideration should be given to the terms of the reinsurance agreements and the creditworthiness of the reinsurer. Significant payment terms may be material to the liquidity of the ceding company.

Litigation and Asserted Claims

.39 Frequently, in complex catastrophes, litigation arises among policyholders, regulators, insurers, and reinsurers. This can be related to issues such as how deductibles apply or whether coverage is provided under the policy or other complex issues. As an example, most homeowners' policies cover wind damage but exclude coverage for flood damage, regardless of the cause. The guidance in FASB ASC 450 and SSAP No. 5R should be followed.

Other Audit Considerations

General Distribution Versus Limited Distribution Audit Opinions

.40 If an insurance enterprise's audited statutory-basis financial statements are intended for general use, the auditor is required to use the standard form of report described in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), modified as appropriate because of the departures from GAAP. When the audited statutory-basis financial statements are intended for general use, auditing standards require the auditor to express an adverse opinion regarding the fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States and then to express an opinion regarding the fair presentation of the financial statements in accordance with statutory accounting principles prescribed or permitted by the domiciliary regulator. If the audited statutory-basis financial statements are not intended for general use, an adverse opinion with respect to GAAP is not required, but the auditor's report must include a paragraph restricting the use of the report to the insurance enterprise and its insurance regulators.

.41 Some insurance enterprises and users of financial statements have expressed concerns regarding the inclusion of an adverse opinion on statutory-basis financial statements regarding fair presentation in accordance with

GAAP when they were never intended to be presented in accordance with GAAP. Auditors may be asked to issue a restricted use paragraph, as permitted by AU section 623, *Special Reports* (AICPA, *Professional Standards*). However, Interpretation No. 15, "Auditor Reports on Regulatory Accounting or Presentation When the Regulatory Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request," of AU section 623 (AICPA, *Professional Standards*, AU sec. 9623 par. .96–.98), affirms the specifics of paragraph .05*f* of AU section 623 and AU section 544, *Lack of Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*). Interpretation No. 15 states that the auditor is precluded from using the form of the report set forth in AU section 623 "in circumstances in which the entity distributes the financial statements to parties other than the regulatory agency either voluntarily or upon specific request."

.42 The auditor should generally discuss with management of the insurance enterprise the requirements under the auditing standards and the insurance company's intention or prior practices relative to distribution of the audited statutory-basis financial statements. Unless the insurance enterprise also has available audited GAAP-basis financial statements, it is likely that the audited statutory-basis financial statements will be requested by, and distributed to, third parties other than state insurance departments (for example, rating agencies, agents, brokers, bankers, policyholders, reinsurers, and so on).

Unclaimed Benefit Liabilities in the Life and Annuity Industry

.43 In the early 1970s, the unclaimed property custodians for large states began audits of holders of unclaimed property. By the end of the decade, most states had intensified their efforts to identify and recover unclaimed property. The conversion of several mutual life insurance companies to stock companies resulted in the escheating of demutualization proceeds for policyholders that the companies could not locate. Many of these policyholders were subsequently discovered to be deceased. This raised the issue of escheatment of unclaimed death benefits. As the custodian of unclaimed property, all benefits of the property belonging to the owner of the property inure to the state, including interest and dividends. Recently, life insurance companies have become the subject of unclaimed property audits and examinations. These examinations have identified, in some cases, unclaimed benefits that did not have appropriate liabilities established.

.44 If an insured dies with an active life insurance policy, and no beneficiary claims the death benefit, several possible scenarios could result. If the policy has an automatic premium loan provision, loans could be taken from the cash value of the policy and used to pay the premiums until the cash value is depleted, and the policy terminates. If the policy is converted to extended-term insurance, the policy remains in force until the period of extended-term insurance has expired. If the policy converts to reduced paid-up insurance, the policy remains in force at a reduced death benefit until the insured would have attained the highest age used in the mortality table plus a statutory dormancy period (usually two years); then, the reduced death benefit amount is frequently escheated to the appropriate states' custodians. Finally, if the policy has no cash value, it is declared terminated.

.45 When an insured individual dies, the life insurance benefits become a liability of the company. Until the company is notified of the claim, the liability should be reported as incurred but not reported (IBNR) reserves. Because the policy has a liability established for the reserves, the IBNR amount is the death benefit less the reserves maintained for the policy. Section 6(b)(iv) of SSAP No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*, describes the IBNR claims as a "[l]iability for which a covered event has occurred (such as death . . .) but has not been reported to the reporting entity as of the statement date."

.46 In May 2011, Florida and California held public hearings related to unclaimed benefits held by life insurers. Efforts to identify deceased insured persons and locate beneficiaries were questioned. The primary focus of the hearings was on the market conduct issues related to insurers using the Social Security Death Index and other tools to identify annuitants who were deceased in order to terminate their annuity payments but not using the same tools to identify deceased individuals with life insurance in force. This matter was referred to the NAIC in order to establish better market conduct examination procedures, and market conduct examinations of a number of large insurers are underway.

.47 Unclaimed benefits, which are eventually escheatable to the state, are based on the books and records of the company establishing the owner of the benefit who has failed to claim the benefit during a prescribed dormancy period. Possession or use of the Social Security Death Index (often used to terminate payments on annuities) or other death verification tools was argued to constitute constructive knowledge of death; therefore, the unclaimed benefits eventually become unclaimed benefits escheatable to the appropriate state after meeting the dormancy period. Unclaimed benefits should be reflected in IBNR reserves until they have been held for the dormancy period. After the dormancy period, the reserves are released, and the entire death benefit becomes an escheat liability until the funds are remitted to the appropriate state. The amount reported as IBNR affects statutory and GAAP financial statements.

.48 Lastly, companies may be subject to additional liabilities in the form of penalties, fines, assessments, or restitution related to this subject area evolving from market conduct or other regulatory agency examinations or investigations should the company be in violation of state laws governing unclaimed benefits.

.49 An auditor should ask several questions when reviewing the books and operations of a life and annuity insurance company, such as the following:

- Does the company use available information to determine if insured individuals are deceased?
- Does the company have appropriate unclaimed benefits procedures in place?
- What procedures are in place for determining whether insured persons are deceased when there is returned mail or failure of automatic bank drafts?
- What efforts are made to contact beneficiaries when an insured person is reasonably believed to be deceased?
- Does the company check that an insured is not deceased before converting a policy to nonforfeiture benefits?
- Does the company establish IBNR to include death benefits that are never claimed or based only on the historical experience of death benefits that have been claimed?

- Does the company escheat death benefits after the dormancy period has elapsed after the death of the insured, or does it only escheat death proceeds after the insured individual's age has reached the limiting age of the reserving mortality table?
- When the company escheats death benefits to the state, does it include all benefits, such as interest and dividends, that would be payable to the beneficiaries?
- How does the company handle matured deferred annuities?

Accounting Considerations

Accounting Standards Update No. 2010-26

.50 In October 2010, FASB released Accounting Standards Update (ASU) No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*.

.51 ASU No. 2010-26 clarifies that insurance entities can capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:

a. Incremental direct costs of contract acquisition

b. The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

   i. Underwriting

   ii. Policy issuance and processing

   iii. Medical and inspection

   iv. Sales force contract selling

c. Other costs related directly to the insurer's acquisition activities in item *b* that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred

d. Advertising costs that meet the capitalization criteria in FASB ASC 340-20-25-4

.52 The FASB ASC glossary defines *incremental direct costs of contract acquisition* as a cost to acquire an insurance contract that has both of the following characteristics:

a. It results directly from, and is essential to, the contract transaction(s).

b. It would not have been incurred by the insurance entity had the contract transaction(s) not occurred.

.53 ASU No. 2010-26 (now included in FASB ASC 944-30-55-1) discusses the types of incremental direct cost of contract acquisition to be capitalized. Such costs include the following:

a. An agent or a broker commission or bonus for successful contract acquisition(s)

b. Medical and inspection fees for successful contract acquisition(s)

.54 It is expected that insurance entities will be able to defer fewer costs under ASU No. 2010-26 than under the current GAAP guidance in FASB ASC 944-30 because the new guidance limits the definition of deferrable acquisition costs to costs directly related to the successful acquisition of insurance contracts.

.55 The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. Insurance entities may adopt the guidance in this ASU prospectively or retrospectively.

Technical Question and Answer on Retrospective Application

.56 In July 2011, the AICPA staff, helped by industry experts, released a set of Technical Questions and Answers (TIS) on the retrospective application of ASU No. 2010-26: TIS section 6300.37, "Application of Accounting Standards Update No. 2010–26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*," and TIS section 6300.38, "Retrospective Application of ASU No. 2010-26" (AICPA, *Technical Practice Aids*). TIS section 6300.38 answers the following questions:

- If different levels of historical information are available for various products, how should this information be included when retrospectively applying ASU No. 2010-26?
- Can ASU No. 2010-26 be applied retrospectively to different points in time for various products?

.57 As stated in the reply of TIS section 6300.38:

> If the entity has determined that it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods (as discussed in paragraphs 5–7 of FASB ASC 250-10-45) for all contracts subject to ASU No. 2010-26 and is applying the new accounting principle as if the change was made prospectively as of the earliest date practicable (in accordance with FASB ASC 250-10), the effect of applying a change in accounting principle for deferral of acquisition costs should be applied at a single point in time to contracts that were entered into from the point of retrospective application and forward.

.58 Auditors should refer to the complete TIS section 6300.38 for a full understanding of the question and reply.

Working Draft of Chapter 10 in the Audit and Accounting Guide Life and Health Insurance Entities *to Address ASU No. 2010-26*

.59 In August 2011, the Financial Reporting Executive Committee (FinREC) issued a working draft of the accounting content of chapter 10, "Commissions, General Expenses, and Deferred Acquisition Costs," of the Audit and Accounting Guide *Life and Health Insurance Entities* to address new accounting issues related to ASU No. 2010-26. The working draft included the new guidance from ASU No. 2010-26, as well as two illustrative examples of how to determine deferrable acquisition costs for an employee whose primary responsibility is interacting with applicants and selling insurance policies.

.60 Informal comments on the working draft were accepted through October 14, 2011. The revised chapter will be included in the Audit and Accounting Guide *Life and Health Insurance Entities* when it is finalized.

On the Horizon

.61 Auditors should keep abreast of accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the insurance industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.62 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to the Audit Risk Alert *General Accounting and Auditing Developments—2011/12* (product no. 0223312) for further information.

Insurance Contracts

.63 As a continuation of the International Accounting Standards Board's (IASB's) insurance contracts project, in July 2010, the IASB issued an exposure draft, *Insurance Contracts*. In September 2010, FASB issued a discussion paper, *Preliminary Views on Insurance Contracts*, to solicit broad-based input on how to improve, simplify, and converge the financial reporting requirements for insurance contracts.

.64 Since the issuance of the exposure draft and discussion paper, the boards have been redeliberating significant issues based on feedback received. It is expected that FASB will issue an exposure draft during the first half of 2012 and that the IASB will either re-expose or issue a working draft for comment early in 2012.

.65 The IASB's 2010 exposure draft proposed a comprehensive measurement approach for all types of insurance contracts issued by entities and reinsurance contracts held by entities, with a premium allocation approach for some short-duration contracts. The comprehensive measurement approach is based on the principle that insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows (premiums) and outflows (benefits and claims).

.66 The following is a summary of some of the key issues in the project and also some of the more significant changes that the boards have tentatively agreed to make.

Measurement

.67 The boards have tentatively concluded that an insurer would apply to the portfolio of cash flows a measurement approach that uses the following building blocks:

- A current estimate of the future cash flows. Measurement should be a current, explicit, unbiased estimate of the expected value using the mean (it does not need to identify or quantify all possible scenarios; however, all available information should be considered), and it is remeasured each reporting period, with changes recognized in earnings.

- A discount rate reflective of the characteristics of the liability, not the invested assets, that adjusts those cash flows for the time value of money.
- IASB—dual margin with an explicit risk adjustment.
- FASB—a single residual margin.

Current Estimate of Future Cash Flows

.68 This is a change from the IASB's exposure draft that stated to use explicit, unbiased, probability-weighted cash flows.

.69 The boards have also tentatively concluded to clarify that all costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to determine the insurance liability. FASB has tentatively concluded to be consistent with ASU No. 2010-26 and only include acquisition costs related directly to the successful acquisition of new or renewal insurance contracts. The IASB has tentatively concluded to include the related acquisition costs for all efforts (successful and unsuccessful). The boards have also tentatively concluded that acquisition costs should be determined at the portfolio level, as compared with the contract level, as noted in the exposure draft.

Discount Rate

.70 The boards have tentatively concluded that methods for determining the discount rate will not be provided. The boards have also tentatively concluded that all contracts should be discounted unless the effect is immaterial.

Dual or Single Margin

.71 Currently, the tentative conclusions of FASB and the IASB differ on whether to use a dual or single margin approach within the building blocks. The IASB has tentatively concluded to use a dual margin with an explicit risk adjustment (compensation that the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfills the insurance contract).

.72 This is a change from the IASB's exposure draft that stated that the explicit risk margin is an explicit assessment of the maximum amount that the insurer rationally would pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected.

.73 FASB has tentatively concluded to reflect risk and uncertainty implicitly through a single margin. The single margin is measured at inception to eliminate any day-one gains and is not remeasured. FASB has currently been discussing that an insurer is released from risk for the purpose of recognizing the single margin in profit, as follows:

a. If the variability of the cash flows of a specified uncertain future event is primarily due to the timing of that event, an insurer is released from risk on the basis of reduced uncertainty in the timing of the specified event.

b. If the variability of the cash flows of a specified uncertain future event is primarily due to the frequency and severity of that event, an insurer is released from risk as variability in the cash flows is reduced as information about expected cash flows becomes more known throughout the life cycle of the contract.

.74 The boards continue to discuss whether the two approaches could be made comparable through disclosures.

Measurement—Short-Duration Contracts

.75 Under the IASB's exposure draft, for most short-duration contracts (with a coverage period of one year or less), a premium allocation approach would apply for preclaim liabilities.

.76 An insurer would measure its preclaim obligation at initial recognition as the premium received at initial recognition plus the expected present value of future premiums less the incremental acquisition costs.

.77 The insurer would subsequently reduce the preclaims obligation over the coverage period in a way that best reflects the exposure from providing coverage (on the basis of the passage of time but on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time). The *preclaim liability* is the preclaim obligation less the expected present value of future premiums. Under the current IASB model, liabilities for claims incurred (after the preclaim period) are measured at the present value of fulfillment cash flows under the general measurement model (building blocks approach). The current FASB model would value the incurred claims without any margin.

.78 The boards continue to redeliberate whether the premium allocation approach is a simplified approach of the building block approach or a modified approach (different than the building block approach). The boards also continue to discuss the eligibility criteria for contracts to be allowed to apply the premium allocation approach (whether to focus on contracts of approximately one year or expanded criteria focusing on the attributes of most contracts considered short duration under U.S. GAAP).

Unbundling

.79 Some insurance contracts contain one or more components that would be within the scope of another standard if the insurer accounted for those components as separate contracts. The IASB's exposure draft requires that if the component is not closely related to the insurance coverage specified in the contract, an insurer should account for that component as if it were a separate contract (referred to as unbundling).

.80 The boards continue to redeliberate the criteria to determine which components of an insurance contract should be unbundled. The boards have tentatively concluded that an explicit account balance should be separated from an insurance contract using criteria based on those being developed in the revenue recognition project for identifying separate performance obligations. The boards will further consider the definition of an explicit account balance.

Presentation

.81 The IASB's exposure draft proposed a new presentation for the statement of comprehensive income. An insurer should not present premiums, claims expenses, claims handling expenses, incremental acquisition costs, and other expenses included in the measurement of the insurance contract in the statement of comprehensive income. These items would instead be treated as deposit receipts and repayment of deposits.

.82 In current discussions, the boards have indicated a preference for a presentation model (outlined in example 2 of appendix A of *Agenda Paper 3A/FASB Memo No. 70A*) that provides volume information on the face and presents the underwriting results of contracts measured under the building block approach separately from contracts measured under the premium allocation approach, as follows:

a. Line items for the underwriting margin of insurance contracts that present the following amounts for the reporting period:

   i. A building block approach underwriting margin reflection as follows:

      (1) A change in, or release of the following: risk adjustment (IASB), residual margin (IASB), or single margin (FASB)

      (2) An experience adjustment related to the current period disaggregated as follows: premiums due, claims incurred, expenses incurred, or expected net changes in the liability for the period

      (3) Changes in assumptions

      (4) Gains and losses at initial recognition

   ii. A premium allocation approach underwriting margin reflection as follows:

      (1) A change in, or release of, the following: risk adjustment (IASB) or a single margin (FASB is applicable)

      (2) Premium revenue (based on the release of the preclaims obligation grossed up for amortization of acquisition costs)

      (3) Claims incurred

      (4) Expenses incurred

      (5) Amortization of acquisition costs included in the preclaims obligation

      (6) Experience adjustments related to the current period

      (7) Changes in assumptions

      (8) Changes in additional liabilities for onerous contracts

   iii. Investment performance, as follows:

      (1) Investment income

      (2) Interest accrued on the expected net cash flows

      (3) Changes in discount rate

.83 Readers are encouraged to stay abreast of the project and review the project page on the FASB and IASB websites at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%

2FProjectUpdatePage&cid=1175801889812 and www.ifrs.org/Current+Projects/IASB+Projects/Insurance+Contracts/Insurance+Contracts.htm, respectively.

Revenue Recognition

.84 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards.

.85 In June 2010, the IASB and FASB issued a joint exposure draft, *Revenue from Contracts with Customers*. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in International Financial Reporting Standards. Under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*.

.86 The boards have been redeliberating significant issues based on feedback received on the exposure draft. The boards are expected to issue for public comment a joint exposure draft during the fourth quarter 2011 for a 120-day comment period.

.87 The core principle of the draft standard continues to be that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration that the entity receives, or expects to receive, from the customer.

.88 Although insurance contracts (within the scope of FASB ASC 944) are scoped out of the draft standard, other products or services offered by insurance entities may be included in the scope, such as administrative services organization services, investment advisory services, asset management, or brokerage activities. Readers are encouraged to stay abreast of the project and review the project page on the FASB and IASB websites at http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011146 and www.ifrs.org/Current+Projects/IASB+Projects/Revenue+Recognition/Revenue+Recognition.htm, respectively.

Overhaul Project—Audit and Accounting Guide *Property and Liability Insurance Entities*

.89 The AICPA is continuing to make progress overhauling the Audit and Accounting Guide *Property and Liability Insurance Entities*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued.

.90 In June 2011, FinREC issued a working draft of the accounting content of the proposed Audit and Accounting Guide *Property and Liability Insurance Entities*. This working draft does not include general and specific auditing considerations, analytical procedures, internal control considerations, or reporting. Informal comments on the working draft of the accounting content of the proposed Audit and Accounting Guide *Property and Liability Insurance Entities* were accepted until October 29, 2011.

.91 During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Resource Central

.92 The following are various resources that practitioners engaged in the insurance industry may find beneficial.

Publications

.93 Practitioners may find the following publications useful. Choose the format best for you—online or print:

- Audit and Accounting Guide *Life and Health Insurance Entities* (2011) (product no. 0126311 [paperback] or WLH-XX [online])
- Audit and Accounting Guide *Property and Liability Insurance Entities* (2011) (product no. 0126711[paperback] or WPL-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099110 [paperback] or WIF-XX [online])
- Checklists and Illustrative Financial Statements *Life and Health Insurance Entities* (product no. 0089510 [paperback])
- Checklists and Illustrative Financial Statements *Property and Liability Insurance Entities* (product no. 0089610 [paperback])

Member Service Center

.94 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.95 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.96 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

AICPA Industry Expert Panel—Insurance

.97 For information about the activities of the AICPA Insurance Industry Expert Panel, visit the panel's website at www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Insurance_Entities.aspx.

Industry Websites

.98 The Internet covers a vast amount of information that may be valuable to auditors of insurance entities, including current industry trends and developments. Some of the more relevant sites for auditors with insurance entity clients include those shown in the following table.

Organization	***Website***
Alabama Insurance Underwriting Association	www.alabamabeachpool.org
Citizens Property Insurance Corporation of Florida	www.citizensfla.com
Florida Hurricane Catastrophe Fund	www.sbafla.com/fhcf
Insurance Information Institute	www.iii.org
Louisiana Citizens Property Insurance Corporation	www.lacitizens.com
Mississippi Residential Property Insurance Underwriting Association	www.msplans.com/MRPIUA
Mississippi Windstorm Underwriting Association	www.msplans.com/mwua
National Association of Insurance Commissioners	www.naic.org/
Texas Windstorm Insurance Association	www.twia.org

.99 The insurance practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.